SULLIVAN & CROMWELL LLP

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CFTC Staff Issues Final Swap Dealer *De Minimis* Exception Report

The Staff of the CFTC Publishes Its Final Report on the *De Minimis* Exception to the Definition of "Swap Dealer" Under the Commodity Exchange Act

SUMMARY

On August 15, 2016, the staff of the Commodity Futures Trading Commission (the "CFTC") released a final report (the "Final Report") regarding the *de minimis* exemption from swap dealer registration under the Commodity Exchange Act (the "CEA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank"). The Final Report supplements the staff's preliminary report dated November 18, 2015 (the "Preliminary Report") and provides a summary of comments received and further analysis of data related to the *de minimis* exception. The *de minimis* exception provides that a person shall not be deemed to be a swap dealer unless its swap dealing activity exceeds a specified aggregate gross notional amount threshold over any prior 12-month rolling period (which currently is set at a phase-in threshold of $8 billion, but will automatically reduce to $3 billion on December 31, 2017 absent further formal action by the CFTC). The Final Report discusses comments received on several alternatives regarding the *de minimis* exemption including (1) setting the gross notional *de minimis* threshold at an amount that is higher or lower than $3 billion, (2) setting a notional *de minimis* threshold specific to each asset class, (3) applying a *de minimis* threshold that factors in a market participant's number of counterparties or transactions and (4) excluding swaps that are executed on a swap execution facility ("SEF") or a designated contract market ("DCM") or cleared through a derivatives clearing organization ("DCO") from an entity's *de minimis* calculation. The Final Report also provides analysis of an additional one-year period of data from the Preliminary Report and identifies key issues for the CFTC to consider.

BACKGROUND

Section 1a(49) of the CEA broadly defines a "swap dealer" as any person that: holds itself out as a dealer in swaps, makes a market in swaps, regularly enters into swaps with counterparties in the ordinary course of business for its own account,[1] or engages in any activity causing the person to be commonly known in the trade as a dealer or market-maker in swaps. Swap dealers are subject to a variety of regulatory requirements including registration, minimum capital, margin, recordkeeping, reporting and business conduct standard. As noted above, the CEA provides an exemption from the designation as a swap dealer for a person that engages in a "*de minimis*" quantity of swap dealing in connection with transactions with or on behalf of its customers.

In final rules approved by the CFTC and the Securities and Exchange Commission (the "SEC," together with the CFTC the "Commissions"), on April 20, 2012, the Commissions set the *de minimis* threshold at $3 billion aggregate gross notional value of swap dealing in the preceding 12 months, representing a rough estimate of 0.001 percent of the aggregate gross notional amount of swaps in the U.S. swaps market. However, the Commissions set an initial phase-in threshold of $8 billion on the assumption that using this threshold would still result in the registration of the market participants responsible for the vast majority of dealing activity within the swap markets.[2] These entity definition rules require the CFTC staff to complete and publish a report "on topics relating to the definition of the term 'swap dealer' and the *de minimis* threshold" (*i.e.*, the Final Report).[3] Nine months after any such report, the CFTC may terminate the phase-in period by order published in the Federal Register or propose through public rulemaking an alternative to the $3 billion *de minimis* threshold.[4] If the CFTC takes no action after the publication of the

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1 The CFTC has interpreted this category to refer only to transactions entered into for the purpose of accommodating a counterparty's interest or that are structured to address a counterparty's needs, not transactions entered into solely for proprietary purposes. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Participant" and "Eligible Contract Participant," 75 Fed. Reg 80174, 80177 (December 21, 2010) available at: http://www.gpo.gov/fdsys/pkg/FR-2010-12-21/pdf/2010-31130.pdf.

2 Please see our memorandum to clients entitled "CFTC and SEC Issue Final Swap-Related Rules Under Title VII of Dodd-Frank" dated June 8, 2012, available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_CFTC_and_SEC_Issue_Final_Swap_Related_Rules.pdf.

In addition, certain swaps are not required to be included in a person's *de minimis* calculation, subject to a number of conditions, including for example: swaps related to loans made by insured depository institutions, certain swaps between affiliates, swaps between cooperatives and their members, swaps hedging physical positions, swaps by certain floor traders, certain cross-border swaps executed outside of the U.S., FX swaps and FX forwards that are settled by actual exchanges of currencies, commodity trade options and swaps resulting from portfolio compression. Additionally, certain inter-governmental international financial institutions and government-related entities are exempted from the definition of "swap dealer."

3 17 C.F.R. § 1.3(ggg)(4)(ii)(B).

4 17 C.F.R. § 1.3(ggg)(4)(ii)(C). In connection with publishing an alternative, the CFTC must publish an order providing notice of this determination and establishing the phase-in terminate date. *See id*.

report, the phase-in period will terminate on December 31, 2017 – meaning that the *de minimis* threshold will be automatically reduced to $3 billion at such time.[5]

REVIEW OF THE *DE MINIMIS* REPORT

The staff of the CFTC received 24 comment letters in response to the Preliminary Report.[6] The Final Report notes that, despite some improvements in the SDR reporting of some market participants, many of the key data limitations discussed below that were identified in the Preliminary Report also affect the Final Report. The Final Report notes that several measures to improve the quality of swap data are forthcoming, including Draft Technical Specifications for certain Swap Data Elements which have been issued for public comment as well as the amendments related to the reporting of cleared swaps, which were finalized in June 2016.

For the Final Report, the staff of the CFTC analyzed data for an additional one-year period following the Preliminary Report. The data was obtained from the swap data reports made by market participants as mandated by CFTC regulations. The staff reviewed data regarding credit default swaps ("CDS"), interest rate swaps ("IRS"), non-financial commodity swaps, foreign exchange derivatives and equity swaps reported to the four registered swap data repositories ("SDRs") – the Chicago Mercantile Exchange Swap Data Repository, DTCC Data Repository, ICE Trade Vault, and Bloomberg SDR – during a period beginning April 1, 2015 and ending March 31, 2016 (the "Final Review Period"), building on the data analyzed for the Preliminary Report during a period beginning April 1, 2014 and ending March 31, 2015 (the "Preliminary Review Period"). The SDRs do not include data fields to indicate whether a transaction is entered into for dealing purposes. Therefore, like the Preliminary Report, the Final Report used various assumptions to identify whether particular entities were engaged in swap dealing. Additionally, reliable notional information was only available for IRS and CDS. Therefore, the staff was required to use alternative measures to analyze other types of swaps. Although the aggregate notional amount of transactions lacking a valid legal entity identifier ("LEI") in the Final Review Period decreased to approximately 5% (from 23% in the Preliminary Report), the SDR data lacked complete LEI and unique swap identifier information, resulting in the use of other identifying information to link swaps manually to the correct counterparties.

PROPOSED ALTERNATIVES FOR THE *DE MINIMIS* EXCEPTION

As noted above, the Final Report reviews the comments received on alternatives to the current notional *de minimis* threshold including (1) setting the gross notional *de minimis* threshold at an amount that is

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5 17 C.F.R. § 1.3(ggg)(4)(ii)(D).

6 For further discussion of the Preliminary Report, please see our memorandum to clients entitled "CFTC Staff Issues Swap Dealer *De Minimis* Report" dated December 3, 2015, available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_CFTC_Staff_Issues_Swap_Dealer_De_Minimis_Report.pdf.

higher or lower than $3 billion, (2) setting a notional *de minimis* threshold specific to each asset class, (3) developing a *de minimis* threshold that factors in a market participant's number of counterparties or transactions and (4) excluding swaps that are executed on a SEF or a DCM and/or cleared from an entity's *de minimis* calculation.

A. HIGHER OR LOWER GROSS NOTIONAL *DE MINIMIS* THRESHOLD

Based on the information regarding notional sizes that is available with respect to CDS and IRS during the Final Review Period, the staff estimates that a *de minimis* threshold set at $3 billion would have required registration by up to 84 additional potential swap dealing entities, and brought within swap dealer regulation an additional $365 billion in notional activity (approximately less than a 1% increase during the Final Review Period), 7,538 swaps (roughly less than 1%) and 821 unique counterparties (roughly an additional 4%). Increasing the limit to $15 billion would have removed 34 entities, $340 billion in activity (~1% decrease), 6,348 swaps (~1% decrease), and 144 unique counterparties (~1% decrease) from swap dealer regulation. The Final Report suggests, as did the Preliminary Report, that the data "appears to indicate that only a substantial increase or decrease in the *de minimis* threshold (e.g., an increase to $100 billion or a decrease to $1 billion) would have an appreciable impact on regulatory coverage as measured by notional amount, transactions, or unique counterparties." Commissioner Giancarlo has advocated against reducing the *de minimis* threshold below $8 billion, stating that "[u]ndoubtably, it would have the effect of causing many non-financial companies to curtail or terminate risk-hedging activities with their customers, limiting risk-management options for end-users and ultimately consolidating marketplace risk in only a few large swap dealers,"[7] thereby increasing systemic risk, counter to the policy goals of Dodd-Frank. The majority of commenters stated that the *de minimis* threshold should remain at $8 billion or be raised. In support of this position, 14 commentators pointed to the data-quality issues. Twenty commentators stated that the policy goals of the exception would be better advanced by maintaining or raising the threshold, noting that lowering the threshold could lead to increased concentration in the swap dealing market, reduced availability of potential swap counterparties, reduced liquidity, increased volatility, higher fees and reduced competitive pricing. Only two commenters recommended that the planned drop to $3 billion should be maintained, citing the lack of evidence to justify raising the threshold or maintaining the threshold at $8 billion and the benefits of increasing regulatory oversight and the number of registered entities. In addressing the topic in the Final Report, and without endorsing a specific approach going forward, the staff of the CFTC concluded its review by noting that "the [CFTC] may want to consider whether to set the [*de minimis* threshold amount] at its current $8 billion level, allow the threshold to fall to $3 billion as scheduled, or delay the reduction of the *de minimis* threshold while the [CFTC] continues its efforts to improve data quality so that it can better determine the appropriate *de minimis* threshold level."

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[7] Statement of Commissioner J. Christopher Giancarlo Swap Dealer *De Minimis* Exception Preliminary Report, Nov. 18, 2015.

B. DIFFERENT *DE MINIMIS* NOTIONAL THRESHOLD BY ASSET CLASS

The Commissions, in adopting the final swap dealer definition rule, noted that swaps on some asset classes may have higher average notional amounts per swap than others, and therefore could trigger a *de minimis* threshold with fewer trades. The Commissions also stated that establishing different thresholds for different asset classes would increase the costs to market participants of determining if they fall within the regulation by requiring them to consider multiple variables and thresholds, thereby decreasing regulatory certainty. In the Preliminary Report, the staff similarly noted that a more complex *de minimis* calculation, such as multiple varying thresholds, could decrease regulatory efficiency further by increasing the amount of time and resources needed by regulators to monitor and enforce the exception. Six commentators did not support establishing different thresholds for different asset classes due to the risk of market confusion and increased compliance and surveillance burdens. Two commentators thought the threshold may be too high for the non-financial commodity swap market, particularly with respect to the energy swap market. In addressing the topic in the Final Report, and without endorsing a specific approach going forward, the staff of the CFTC concluded its review by noting that "the [CFTC] may want to consider maintaining the current single [*de minimis* exception amount] rather than adopting an asset class-specific approach, or consider the class-specific approach in the future as data quality improves."

C. MULTI-FACTOR *DE MINIMIS* THRESHOLD ALTERNATIVE

In the Preliminary Report, the staff considered the use of some combination of a *de minimis* threshold test that considers the number of counterparties and transactions entered into by a person, along with the existing gross notional swap dealing activity benchmark. In their final rules, the Commissions considered the use of these alternative factors but expressed concerns that "a standard based on the number of swaps . . . or counterparties can produce arbitrary results by giving disproportionate weight to a series of smaller transactions or counterparties." The Preliminary Report notes that "there may be meaningful distinctions in levels of activity as measured by Counterparty Counts" but concludes that a "Transaction Count appears to be less indicative of dealing activity size as compared to [a] Counterparty Count, and therefore, may be less effective as an alternative or additional metric for the *de minimis* exception." Eleven commenters opposed the use of the alternative factors of Counterparty Count or Transaction Count because they are misleading or arbitrary indicators of dealing activity, stating that the alternatives are not indicative of dealing activity, the use of the alternative factors could constrain firms' business models or disincentivize market participants from entering into swaps and such an approach would increase the potential for regulatory uncertainty and decrease efficiency by increasing monitoring costs for both market participants and the CFTC. Two commenters supported the use of alternative factors, stating that a multi-factor test could avoid arbitrary outcomes by taking into account more characteristics of an entity's swap activities. In addressing the topic in the Final Report, the staff of the CFTC concluded its review by noting that "[b]ased on the analysis in the Preliminary Report, the [CFTC] may want to consider maintaining a single *de minimis* threshold based on [gross notional swap dealing activity]."

D. EXCEPTION FOR SWAPS EXECUTED ON A SEF OR DCM AND/OR CLEARED

Certain categories of swaps are required to be cleared through a registered DCO and executed on a SEF or DCM, if available, unless an exception applies. The Final Report states that "the execution of swaps on SEFs and DCMs enables market participants to view the prices of available bids and offers and provide access to transparent and competitive trading systems or platforms." The Final Report also notes that the Dodd-Frank fundamental goal of reducing systemic risk may be achieved by requiring central clearing of more swaps. Once a swap is cleared, the clearing organization is responsible for the risk management and mitigation of the swap. Because of the foregoing, the Preliminary Report raised the possibility of excluding transactions executed on a SEF or DCM or cleared as "swap dealer regulation may be of limited value with regard to swaps that are executed on a SEF or DCM and/or cleared." Commissioner Giancarlo has advocated only counting a dealer's remaining uncleared swaps toward the *de minimis* threshold. Nine commentators supported the exclusion of swaps that are executed on a SEF or DCM or cleared from the *de minimis* threshold calculation, stating that such swaps are already effectively regulated. One commentator opposed the exclusion of these swaps, stating that the intent of the Dodd-Frank Act was to require registration of all entities holding themselves out as dealers, regardless of execution and clearing. The Final Report states that the staff had not yet evaluated the effectiveness of clearing mandates, margin requirements on uncleared swaps and capital requirements in connection with the oversight of swap dealers. In addressing the topic in the Final report, and without endorsing a specific approach going forward, the staff of the CFTC concluded its review by noting that "after further study, the [CFTC] may want to consider in the future whether to exclude swaps that are traded on a SEF or DCM and/or cleared from an entity's swap dealing activity."

OTHER COMMENTS

A. INSURED DEPOSITORY INSTITUTION EXCLUSION

Seven commentators stated that the scope of the exclusion for swaps related to loans made by insured depository institutions should be expanded to provide banks with greater flexibility, stating that it would be more aligned with current lending practices. The Final Report identified obtaining further information to determine whether this exclusion is overly restrictive as a key consideration for the CFTC.

B. IMPACT OF CAPITAL AND MARGIN RULES

Nine commenters opposed considering any change to the current *de minimis* threshold until the CFTC's new capital and margin requirements are fully implemented, so that market participants can assess the impact of those rules. The Final Report notes that the regulations regarding margin for uncleared swaps were adopted on January 6, 2016, subject to a phased-in compliance schedule beginning on September 1, 2016. The CFTC has not yet adopted final regulations addressing swap dealer capital requirements.

C. MULTI-TIERED SWAP DEALER REGULATION ALTERNATIVE

The Preliminary Report identified a distinct group of large dealers with levels of swap dealing activity that are substantially higher than other entities engaged in swap dealing. The Preliminary Report raised the possibility of creating two tiers of swap dealer regulation based on two different gross notional thresholds. The group of market participants with the greater activity would be subject to more comprehensive regulatory requirements, and the lower tier would be subject to fewer requirements. For example, the CFTC could adopt a lower gross notional threshold, above which some limited swap dealer regulation applies, but the full spectrum of current swap dealer regulation would only apply if the entity also exceeded a higher secondary threshold. In the Preliminary Report, the staff notes that this approach, while it could result in lighter regulation for some currently registered swap dealers, and reduce regulatory certainty due to differing levels of requirements, could increase efficiency by allowing the CFTC to focus more of its resources on the smaller number of highest-activity dealers while still addressing the unique concerns of certain types of entities such as smaller non-financial commodity swap dealers and small and mid-sized banking enterprises. The Final Report did not comment on the possibility of multi-tiered swap dealer regulation.

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CONTACTS

New York		
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
John M. Miller	+1-212-558-4839	millerjo@sullcrom.com
Ryne V. Miller	+1-212-558-3268	millerry@sullcrom.com
Christine Trent Parker	+1-212-558-3631	parkerc@sullcrom.com
Washington, D.C.		
Dennis C. Sullivan	+1-202-956-7554	sullivand@sullcrom.com